

Reforming Social Security: The Case Against Individual Accounts

There is remarkable agreement among economists on most of the analytical aspects of the Social Security debate (Diamond, 1999). They generally agree that the size of the financing shortfall described in the Social Security Trustees' Annual Report is a reasonable estimate. They agree that questions of prefunding, investing in equities, and defined benefit versus defined contribution are separable from an economic perspective. In principle, it is possible to have a large trust fund with a diversified portfolio in a defined benefit system or a defined contribution system with no more than our current funding. They agree that privatizing without prefunding would not raise the return on Social Security contributions, after making appropriate adjustments for risk and the transition costs. They agree that prefunding can raise future returns, but only by imposing significant costs on those workers who must pay twice—to maintain current benefits and to build up a reserve. They agree that setting up a system of individual accounts can be extremely costly and expose individual participants to risk. They agree that providing access to equity investment for the entire population would improve the distribution of risk bearing in society.

This article argues that these shared facts provide a strong case for retaining the current defined benefit system and not replacing a portion or all of Social Security with a system of individual accounts. The argument is as follows. First, the projected increase in Social Security spending due to the aging of the population is neither enormous nor unprecedented. That is, the size of the financing problem does not require a major restructuring. Second, replacing all or part of Social Security's current defined benefit plan with individual accounts will not, in and of itself, improve the return on Social Security contributions. Third, individual accounts are risky, costly, and will hurt the disabled, women, and low earners generally; but most importantly they create the mechanism for eventually undermining the entire program. Finally, instead of individual accounts, we can increase national savings and broaden investment options for workers—changes that have been used to justify individual accounts—within the structure of the current program.

While dramatic change is unnecessary, this is the time to make some decisions about the future of the program. The

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system has matured so the full cost of providing current levels of benefits has become apparent. We can afford the level of protection provided by today's Social Security program, but should make the choice whether to maintain current benefits. Second, the system's long-term financing gap, while manageable, should be closed as soon as possible.

SOCIAL SECURITY IS NOT FACING A FINANCING CRISIS

Some observers contend that Social Security is facing a financial "crisis" that justifies major changes in the system. (In fact, Samwick in this Forum uses the word "crisis" three times in his opening paragraph.) Therefore, it is worth laying out the dimensions of the financial shortfall so that readers can assess the magnitude of the problem.

Every year, the Social Security's Trustees publish an actuarial report that includes three sets of projections based on alternative assumptions about future rates of population growth, future rates of economic growth, and interest rates. The intermediate projection from the 1999 Report shows that between now and 2013 the Social Security system will bring in more tax revenues than it pays out. From 2013 to 2021, adding interest on trust fund assets to tax receipts produces enough revenues to cover benefit payments. After 2021, annual income will fall short of annual benefit payments, but the government can meet the benefit commitments by drawing down trust fund assets until the funds are exhausted in 2034.¹ It is important to remember that the exhaustion

of the trust funds does not mean the program ends in 2034, and nothing is left. Even if no tax or benefit changes were made, current payroll tax rates and benefit taxation would provide enough money to cover more than 70 percent of benefits thereafter. It is this long-run gap between 70 and 100 percent that needs to be filled.

Over the next 75 years, Social Security's long-run deficit is projected to equal 2.07 percent of covered payroll earnings. That figure means that if the payroll tax rate were raised immediately by two percentage points—one percentage point each for the employee and the employer—the government would be able to pay the current package of benefits for everyone who reaches retirement age at least through 2075. While such a tax increase is neither necessary nor desirable, it provides a useful way to gauge the size of the problem.

Social Security's long-term financing problem is somewhat more complicated than just described. Under current law, the tax rate is fixed while costs are rising, and this pattern produces surpluses now and large deficits in the future. As a result of this profile, under present law, each year the 75-year projection period moves forward, another year with a large deficit is added to the 75-year deficit. Assuming nothing else changes, this phenomenon would increase the 75-year deficit slightly (0.08 percent of taxable payroll with today's deficits) each year. Many policymakers believe that the system should not be left with a huge deficit in the 76th year.²

A very different pattern of costs emerges when Social Security outlays are

¹ Social Security financing will put increasing pressure on the unified federal budget before the trust fund balances are exhausted. Although shortfalls between 2013 and 2034 can be met in a technical sense from the program itself, first by drawing on the interest earned on the trust funds and then by drawing on the funds themselves, these actions will lead to a higher unified deficit unless the government raises taxes, reduces other spending, or increases federal borrowing.

² Stabilizing the trust fund ratio—the ratio of assets to next year's outlays—would achieve this aim. A stable trust fund ratio means that the flows into and out of the trust fund are balanced, and therefore additional years do not increase the deficit, as they are included in the projection period.

projected as a percent of gross domestic product (GDP) rather than as a percent of taxable payrolls. According to the intermediate projections of the 1999 Trustees Report, the cost of the program is projected to rise from 4.5 percent of GDP today to 6.8 percent of GDP in 2030, where it remains. The reason why costs as a percent of GDP stabilize while costs as a percent of taxable payrolls keep rising is that taxable payrolls are projected to decline as a share of total compensation due to a continued projected growth in fringe benefits. A two-percent-of-GDP increase in Social Security costs is significant, but hardly qualifies as a "demographic time bomb" (Peterson 1996, p. 21). Budget changes equal to two percent of GDP are not uncommon; defense spending increased by five percent of GDP at the start of the cold war and declined by two percent between 1991 and 1998.

The basic flaw in the analysis of many Social Security critics is that they tend to lump together the costs of Social Security and Medicare and treat them as a single, overwhelming crisis. In fact, these are two separate programs: they are financed separately and they face distinct problems. Of course, it would be a mistake to ignore completely the fact that the aging of the population will also place increased demands on the Medicare program.³ But only a fraction of Medicare's rising costs comes from demographics; the bulk comes from the growth in health care costs per person. This problem affects medical care throughout the economy and is one that policymakers are going to have to solve. The spread of managed care has provided some encouraging statistics, but reformers of the health care system are far from victory. Thus, both the Medicare and Social Security problems are going to have to be solved, but they have to be solved

separately. When devising solutions for the Social Security program, the right numbers to look at are the costs and revenues for Social Security alone.

Reasonable Assumptions?

Are the Trustees' projections based on sensible economic and demographic assumptions? After all, projecting costs for the next 75 years is equivalent to having made estimates for today in 1924. Forecasters in 1924 would have had no idea about the Great Depression, World War II, or a host of other demographic, economic, and social developments.

On the demographic side, the key variables are fertility and mortality rates. With regard to fertility, currently the average woman would be expected to have 2 children over her lifetime. Demographers agree almost unanimously that fertility rates will remain low. The Trustees' Report assumes that the fertility rate will trend down slightly to 1.9 percent. Some experts view this as a little pessimistic and that future fertility patterns may cause costs to be somewhat lower. The consensus is that mortality will also decrease, but experts disagree about the magnitude of the projected decline (Tuljapurkar and Boe, 1998). Some people believe that the Trustees' projections do not fully account for future improvements in mortality and that costs may be somewhat higher as a result.

On the economic side, a key variable is the difference between the rate at which benefits in payment status increase—namely, increases in the Consumer Price Index (CPI)—and the rate at which taxes rise—namely, the growth in wages. During the 20-year period before 1973, when productivity growth was high, this "real-wage differential" averaged 2.2 percent.

³ Although adding the projected increase in Medicare spending has traditionally produced alarming numbers, recent cuts in the Medicare program have greatly improved its outlook. The costs of the Hospital Insurance program are now projected to rise only from 1.56 percent of GDP in 1999 to 3.06 percent in 2073 (Social Security and Medicare Board of Trustees, 1999).

Since 1973, it has averaged 0.6 percent. The question is how much weight to put on recent years as compared with the pre-1973 period. Despite the current upsurge in productivity growth, which produced a real wage differential of 3.4 percent in 1997 and 4.4 percent in 1998, the Trustees have retained their assumption of 0.9 percent for the 75-year projection period. Most critics are concerned that this assumption is too pessimistic.

How do other experts view the reasonableness of the assumptions as a whole? A 1994–5 Technical Panel to the 1994–6 Social Security Advisory Council concluded that, “The ‘intermediate’ projection . . . for the OASDI program provide(s) a reasonable evaluation of the financial status. Although the Panel suggests that modifications be considered in various specific assumptions, the overall effect of those suggests would not significantly change the financial status evaluation (p. 137).” Similarly, in October 8, 1997 testimony before the House Banking Committee, Alan Greenspan characterized the Trustees’ economic and demographic assumptions as “conservative.” In short, one can quibble with any particular economic or demographic assumption, but taken as a whole they provide a reasonably realistic picture of the future.

Other Considerations

Although Social Security’s financing problems do not require radical changes in the system, two other considerations, which are receiving more attention today than in 1983 when Congress last passed major financing legislation, lead some observers to argue for major restructuring of the program. The first consideration is the so-called “money’s worth” issue. Unlike earlier generations that received large benefits relative to the taxes they paid, today’s workers can expect to receive relatively low returns on their payroll tax contributions. Since raising taxes

or reducing benefits will only worsen returns, almost all reform plans involve trying to increase returns through equity investment in one form or another. The second factor influencing the Social Security reform debate is increasing concern about our low levels of national saving. This concern along with the desire to avoid high pay-as-you-go tax rates in the future has led to considerable interest in some prefunding.

Almost all proposals to restore financial balance to Social Security respond to concerns about rate of return and national saving. Both proposals to maintain Social Security’s existing defined benefit plan and proposals to institute personal saving accounts involve a substantial accumulation of assets. Similarly, most proposals provide that those covered by Social Security should have access to the higher returns associated with equity investment either through investments in individual accounts or through broadening the investment options available to the trust funds. Because it is possible to have equivalent amounts of funding in the Social Security program and in a system of individual accounts and because equity investment is possible in either scenario, the question comes down to which arrangement is better for people’s basic retirement income.

WHAT PRIVATIZATION CAN AND CANNOT DO

Diamond (1998, 1999) and Geanakoplos, Mitchell, and Zeldes (GMZ) (1998) have made enormous contributions toward clarifying the issues underlying proposals to “privatize” the Social Security system. (Mariger in this Forum also makes many of the same points discussed below.) They point out that “privatize” is a vague term that means different things to different people. In fact, designing a pension system involves answering three main questions—whether the program should

be structured as a defined benefit plan or a mixed defined benefit/ defined contribution arrangement, how much advance funding should be undertaken, and how that prefunding should be invested. These questions are quite separable from an economic perspective.

Once the terms are clarified, GMZ then ask whether privatization—that is, sending payroll taxes to Fidelity instead of the Treasury—would raise the rate of return to Social Security. That notion certainly permeates the popular press and statements of politicians. The problem is bipartisan as presidential candidate Senator John McCain indicates in a recent (June 7, 1999) speech:

“My friends, there is only one solution if Social Security commitments are to be honored without breaking the backs of the next generation: bold reform—genuine reform—that allows workers to invest some of their Social Security savings, privately, in higher yielding accounts. This isn’t an exclusively Republican idea. Two well-respected, thoughtful Democrats, Senators Bob Kerrey and Pat Moynihan, have endorsed the idea because they know it is the only way Social Security can be saved without raising taxes or cutting benefits.”

It is true that private market returns are high and Social Security returns are low. The average annual real return on stocks (1926–96) was 9.4 percent; the corresponding return on intermediate term government bonds was 2.3 percent. In contrast, the real return on Social Security contributions is projected to be roughly 1.3 percent. The reason that projected returns on Social Security contributions are low is that, under our pay-as-you-go system, early generations received large net transfers of roughly \$9 trillion, and later generations have to pay the bill. This bill can be paid in any number of ways, but one obvious candidate is that every generation be required to give up the same percent-

age of its earnings. Based on the existing \$9 trillion unfunded liability, roughly 3 percentage points of the current 12.4 percent payroll tax would go toward financing the startup costs. In other words, 25 percent goes to cover the implicit interest costs on the unfunded liability and earns minus 100 percent; 75 percent earns the market rate for bonds of 2.3 percent. This brings the total return on payroll tax contributions close to the projected rate of 1.3 percent.

In thinking about how privatization would affect the return to Social Security, as noted above, it is important to differentiate between privatization (setting up individual accounts in individual workers’ names) and prefunding (putting aside reserves to offset the \$9 trillion liability). Privatization without prefunding will not raise returns on Social Security contributions, after taking account of transition costs and risks. First, consider the transition costs. In a world without uncertainty, workers could send all their new payroll tax contributions to private accounts invested in capital markets and earn higher returns. But then some mechanism must be found to pay off the \$9 trillion of unfunded liability, since no one suggests renegeing on the commitments to current retirees and those nearing retirement. One approach would be to issue recognition bonds to workers and retirees for the full amount of their promised benefits. The government, however, would have to raise new taxes to pay the interest on these bonds. Geanakoplos, Mitchell, and Zeldes show that the new taxes would eliminate all of the higher returns on individual accounts. In other words, the rate of return in the privatized system, net of new taxes, would be identical to the low returns under the existing system.

Second, consider the appropriate treatment of risk. Projected returns on privatized accounts might appear higher because contributions were invested in stocks rather than bonds. But stocks in-

involve considerably more risk than bonds, so their returns need to be adjusted for risk before comparing them with the safe returns from a conventional Social Security system. If all households held both stocks and bonds, they should value an additional dollar of stocks the same as an additional dollar of bonds, even though stocks have a much higher expected return. That is, the risk-adjusted return on stocks and bonds would be identical. In this case, GMZ believes it is appropriate to compare the current system to a privatized system in which the individual accounts were invested only in bonds. This conclusion has to be modified to the extent that some households currently do not have access to equity investment.

In short, privatization without prefunding would not raise returns from Social Security. If prefunding were undertaken either in the trust funds or individual accounts, it would eventually raise returns. But higher returns to future generations would be gained at the expense of lower returns to current generations who have to pay twice, first to cover promised benefits and second to build up reserves. Thus, GMZ conclude "that the popular argument that Social Security privatization would provide higher returns for all current and future workers is misleading . . ." (p. 157). Rather they say the choice involves weighing the greater freedom and control, reduced political risk, and possible reduced labor supply distortions of privatization against the loss of social risk pooling, higher administrative costs, and the costs of allowing workers to make poor investment choices.

INDIVIDUAL ACCOUNTS ARE RISKY, COSTLY, AND HURT THE DISABLED AND WOMEN

Individual accounts may allow greater freedom and control, but they do so at quite a price. Replacing Social Security with individual accounts would expose

individuals to greater risks, significantly increase costs, and likely hurt the disabled, women, and low earners generally.

Individual Accounts Are Risky

Individual accounts expose workers to three risks: market risk, the risk of using their savings before retirement, and the risk of outliving their resources.

With individual accounts, individuals' basic benefits would depend, at least in part, on their investment decisions. What stocks did they buy? When did they buy them? When did they sell? Uncertain outcomes may be perfectly appropriate for supplementary retirement benefits, but not for the basic guarantee. Herb Stein (1997), Chairman of the Council of Economic Advisers under President Nixon, summarized the argument best.

"If there is no social interest in the income people have at retirement, there is no justification for the Social Security tax. If there is such an interest, there is a need for policies that will assure that the intended amount of income is *always* forthcoming. It is not sufficient to say that some people who are very smart or very lucky in the management of their funds will have high incomes and those who are not will have low incomes and that everything averages out."

Retirement income that depends on one's skills as an investor is not consistent with the goals of a mandatory Social Security program. Remember that Social Security is the major source of income for two-thirds of the 65-and-over population and virtually the only source for the poorest 30 percent. The whole point of having a Social Security system is to provide workers with a predictable retirement benefit. Social Security benefits are quite modest; the average worker retiring at age 62 in 1998 got \$780 per month (U.S. Social Security Administration, 1998).

That modest benefit should be an amount that people can count on and to which they can add income from private pensions and other sources. It should not depend on investment decisions in a volatile stock market.

Individual accounts also create a very real political risk that account holders would pressure Congress for access to these accounts, albeit for worthy purposes such as medical expenses, education, or home purchase. Although most proposals prohibit such withdrawals, our experience with existing Individual Retirement Accounts (IRAs) and 401(k)s suggests that holding the line is unlikely. To the extent that Congress acquiesces and allows early access—no matter how worthy the purpose—retirees will end up with inadequate retirement income.

Another risk is that individuals stand a good chance of outliving their savings, unless the money accumulated in their individual accounts is transformed into annuities. But few people purchase private annuities and costs are high in the private annuity market. The reason for the high costs is adverse selection: people who think that they will live for a long time purchase annuities, whereas those with, say, a serious illness keep their cash. Private insurers have to raise premiums to address the adverse selection problem, and this makes the purchase of annuities very expensive for the average person. Moreover, the private annuity market would have a hard time providing inflation-adjusted benefits. In contrast, by keeping participants together and forcing them to convert their funds into annuities, Social Security avoids adverse selection and is in a good position to provide inflation-adjusted benefits.

Individual Accounts Would Be Costly

In addition to making the basic retirement benefit dependent on one's investment skills, individual accounts would be

costly. The 1994–6 Social Security Advisory Council estimates that the administrative costs for an IRA-type individual account would amount to 100 basis points per year. A 100-basis point annual charge sounds benign, but estimates by Diamond of MIT show that it would reduce total accumulations by roughly 20 percent over a 40-year work life. That means benefits would be 20 percent lower than they would have been in the absence of the transaction costs. Moreover, while the 100-basis-point estimate includes the cost of marketing, tracking, and maintaining the account, it does not include brokerage fees. If the individual does not select an index fund, then transaction costs may be twice as high. Indeed, the Advisory Council estimates may be conservative given that costs actually experienced in the United Kingdom, which has a system of personal saving accounts, have been considerably higher (Orszag, Orszag, and Murthi, 1999). Finally, because these transaction costs involve a large flat charge per account, they will be considerably more burdensome for low-income participants than for those with higher incomes.

In addition to costs, a recent study by the Employee Benefit Research Institute (EBRI, 1998) has raised real questions about the ability, in anything like the near term, to administer a system of individual accounts in a satisfactory way. Unlike the current Social Security program that deals with the reporting of wage credits, a system of personal accounts would involve the transfer of real money. It is only reasonable that participants would care about every dollar, and therefore employer errors in account names and numbers that arise under the current program would create enormous public relations problems under a system of individual accounts.

Many advocates of individual accounts have now recognized the very high costs of the IRA approach and have fallen back to recommending a 401(k) or federal Thrift

Savings Plan (TSP) mechanism.⁴ This, however, buys virtually nothing over investing accumulated trust fund reserves directly. First, the TSP approach introduces most of the same unpredictability into retirement income as the IRA-type alternative, since individuals can invest in stocks as well as bonds and fixed-income instruments. Second, while its costs would be lower, it would still double the costs of the current Social Security program. Finally, for those concerned about government involvement, this approach has the government picking the appropriate equity funds and retaining control of the money. This is not a particular problem in my view, but the TSP approach does raise all the same issues about the government interfering in private sector activities as investment by the central trust funds.

Individual Accounts Would Hurt the Disabled, Women, and Low Earners

Most proposals that move toward individual accounts involve a cut in benefits for disabled workers. These proposals typically involve a reduction in Social Security benefit levels for both disabled and retirees that, in theory, workers will make up through lifetime accumulations in their individual accounts. Thus, projections for the various reform proposals generally show for the average retired worker that the combined payment from the personal saving account and the reduced Social Security program equals the benefit currently promised under Social Security. Unlike retirees, however, disabled workers will not have time before their disability to build up any significant reserves in their personal saving account to finance a full supplementary benefit. As a result, disabled workers are likely to experience a substantial reduction in benefits.

Because individual accounts would make it difficult to carry out much of the implicit redistribution in the current system, they would also likely hurt women and low earners generally. Although Social Security's benefit rules are gender neutral, they are particularly helpful for women. First, the progressive benefit formula provides proportionately higher benefits for low earners than for high earners, and women are more likely to be low earners. Second, for women who spend their careers taking care of their families, Social Security provides retirement benefits equal to 50 percent of their husbands' benefits. Divorced homemakers (married at least 10 years) can also get these benefits. Third, for older women whose husbands die, Social Security provides widows' benefits equal to 100 percent of their husbands' benefits. This is important because women tend to outlive their husbands. Fourth, if children are getting survivors' benefits, younger widows who stay home to care for them also receive benefits.

Even with more women in the labor force, these family benefits remain important. In 1996, the majority (63 percent) of women beneficiaries aged 62 and older were receiving wives' or widows' benefits; 37 percent had no earnings history and were entitled only as a wife or widow, and 26 percent had a higher benefit as a wife or widow than as an earner.

All the protections of the current program would be put at risk if reform moved toward individual accounts. First, unless special provisions were enacted, a woman's retirement benefit would depend—at least in part—on her contributions into her personal account and the earnings on those contributions. Because women tend to have lower wages and less time in the labor force, their contributions

⁴ The TSP was established by the Federal Employees' Retirement System Act of 1986. It is a voluntary savings and investment plan similar to the defined contribution plans offered under section 401(k) of the Internal Revenue Code. Individuals can direct their contributions to a stock fund, a money market fund, or a bond fund and can shift their investments over time.

and earnings would, on average, produce low retirement benefits. Second, many of the family benefits currently provided by Social Security would likely be cut back. Third, for women, the lack of automatic annuitization discussed above can be particularly serious, because they live longer than men. In addition, married women face the risk that their husbands use up all the money before they die and leave nothing for them as widows. In short, the present Social Security system offers a range of protections that are of great importance to women and are not duplicated by any of the proposals to privatize the system.

Risks Cannot be Guaranteed Away

Not to worry, say Representatives Bill Archer and Clay Shaw. They have a plan, based on proposals by Martin Feldstein and Samwick (1998) and discussed by Samwick in this Forum, that introduces individual accounts *and guarantees* everyone the full benefits they would receive under the current system. The Archer-Shaw plan restores solvency to Social Security by contributing an additional two percent of taxable earnings to individual accounts and using these balances to pay a major portion of future Social Security benefits. The government would reimburse workers dollar-for-dollar for their individual account contributions through a refundable income tax credit, financed in the short run by surpluses in the Social Security trust funds and, after about 2012, from surpluses in the non-Social Security part of the budget. The proposal requires that 60 percent of all account balances be invested in stock index funds and 40 percent in corporate bonds. At retirement, the account balances are transferred to Social Security to transform into an inflation-indexed annuity. Social Security would then reduce program benefits by \$1 for each \$1 of annuity income. The reductions in Social Security would eventually close the

long-term financing gap. The best of both worlds: workers have individual accounts but are not exposed to any risks.

If Archer-Shaw worked in the long run, it could be viewed as nothing more than a wasteful rearrangement of the current system. It funnels money out of general revenues to costly individual accounts and then funnels it back to Social Security to help pay Social Security benefits. In the interim, workers do not control their investments, they do not have access to their accounts, and they are unlikely to earn higher benefits. But Archer-Shaw is more than inefficient; it is dangerous. Archer-Shaw will not work in the long run and sows the seeds for ultimately destroying the current system.

One possible outcome is the start/stop scenario. The Archer-Shaw plan appears painless in the short term because contributions to individual accounts would be financed by the surpluses. Once the surpluses disappear as the baby boomers retire, continuing to provide tax credits for contributions to individual accounts would require a major hike in taxes, substantial cutbacks in other programs, or a significant increase in borrowing. If the plan is abandoned once the surpluses disappear, Social Security's financing gap will have grown because no steps will have been taken to solve the problem. The pressure to cut benefits will be great because people will have accumulated funds in their individual accounts. These cuts will significantly hurt future retirees who have not been lucky enough to participate in the surplus bonanza.

The alternative outcome is that the Archer-Shaw plan continues, but in this event, opponents of the proposal believe that it will eventually undermine support for Social Security's defined benefit guarantee. High and moderate earners would pay substantial payroll taxes to Social Security over their lifetimes but would lose a large percentage of their Social Security benefits under the offset provision. They

would conclude that Social Security provides little for the 12.4 percent that they and their employers pay into the system. They would also make misleading comparisons between the returns on Social Security and returns on individual accounts. They might conclude—incorrectly—that Social Security was a bad deal, without taking into account that Social Security must pay benefits to earlier generations of retirees, finance disability and survivor insurance, and provide adequate benefits to low-income workers and women who spend time out of the labor force. Thus, the dangerous aspect of the Archer-Shaw proposal is that it makes Social Security contributions look like an unappealing investment, and thereby leads to an unraveling of the current system that—despite the guarantee—puts many of today's protections at risk.

What then is the best approach?

FUND SOCIAL SECURITY AND INVEST IN PRIVATE STOCKS AND BONDS

The alternative to individual accounts is to accumulate reserves in the Social Security trust funds and invest part of those reserves in private stocks and bonds. This approach offers many of the advantages of individual accounts without the risks and costs. It has the potential to increase national saving and offers participants the higher risk/higher returns associated with equity investment. But, unlike personal saving accounts, a partially funded Social Security program with equity investments ensures predictable retirement incomes by maintaining a defined benefit structure that enables the system to spread risks across the population and over generations. In addition, pooling investments keeps transaction and reporting costs to a minimum, producing higher net returns than personal saving accounts.

Accumulating Reserves

Would it really be possible for the federal government to accumulate reserves? A key requirement for success is separating Social Security completely from the rest of the budget. To date, increasing saving through accumulations in the Social Security trust funds has produced ambiguous results. Critics contend that the existence of Social Security surpluses encourages either taxes to be lower or non-Social Security spending to be higher than it would be otherwise. Although little evidence exists to support this contention, a unified budget and large deficits during the 1980s and most of the 1990s blurred the picture to date. But the fiscal outlook has changed; the unified budget is in surplus and the Congressional Budget Office (1999) projects that the non-Social Security portion of the budget will be balanced by 2000.

Revising the presentation of government accounts to separate Social Security completely from the rest of the budget would clarify the extent to which the system is adding to national capital accumulation. Technically, the Social Security Amendments of 1983 already placed the Social Security trust funds "off budget." This legislation reversed the reliance on the concept of the unified budget first used by Lyndon Johnson in FY1969. The difficulty is that, while Social Security is exempt from most enforcement procedures, budget targets are always stated in terms of the unified budget and the budget numbers reported by the Administration, Congress, and the press always include the balances in the trust funds. Thus, separating Social Security from the rest of the budget requires changing culture more than changing legal requirements.

Current Congressional efforts to create a "lock box" for Social Security are aimed at precisely the problems that arise from focusing on the unified budget. The goal

of the lock box is to ensure that Congress does not use surpluses in Social Security to cover deficits in the non-Social Security part of the budget.⁵ These budgetary restrictions should be useful in enabling the federal government to accumulate reserves and add to national saving. It is important to remember, however, that lock box initiatives are designed to limit deficits in non-Social Security spending, not to restore balance to the Social Security program itself.

Is it realistic to evaluate the budget without Social Security? Comparisons of the federal government with the states are always tricky, but states have been successful in this endeavor. They accumulate reserves to fund their pension obligations but generally present their budgets excluding the retirement systems. Their nonretirement budget balance has remained positive, while annual surpluses in their retirement funds have been hovering recently around one percent of GDP.⁶ Thus, states are clearly adding to national saving through the accumulation of pension reserves. With a commitment to balance the non-Social Security portion of the budget, the same should be achievable at the federal level.

Investing in Equities

Equity investment for Social Security is also a feasible option, and a partially funded Social Security program with private stocks and bonds is the realistic alternative to personal saving accounts. Everyone involved in the debate recognizes that having the federal government in the business of picking winners and

losers and voting on corporate proposals is undesirable. Thus, it is essential to establish mechanisms to ensure that the government does not interfere in private sector decisions, and we know how to do that.

For example, trust fund equity investments would be indexed to a broad market average and the goal of investment neutrality be established in law (Ball, 1998; Aaron Reischauer, 1999; Munnell and Balduzzi, 1998). An expert investment board, similar to the Federal Reserve Board or the Federal Retirement Thrift Investment Board that administers the Thrift Savings Plan for federal employees, would be responsible for selecting a broad market index, such as the Russell 3000 or the Wilshire 5000, for trust fund investments. This board would also be responsible for choosing, through competitive bidding, several portfolio managers to manage the accounts and for monitoring the performance of these managers. To ensure that government ownership does not disrupt corporate governance, most proposals require that voting rights be given to the asset managers, not voted at all, or voted in the same fashion as the other shareholders, which is equivalent to not voting at all. Caps on the holdings in any individual company can be introduced to ensure that Social Security does not disrupt financial markets. Moreover, the investment in stocks would occur gradually over a 10- or 15-year period.

Even though equity investment by Social Security would not disrupt the markets, some critics still worry that it could have a substantial effect on relative rates of return, perhaps driving up government

⁵ Although many lock box proposals exist, they are all quite similar to that included in the Social Security and Medicare Safe Deposit Act of 1999, which the House of Representatives passed in May. This legislation changes the budget process so that Congress cannot use Social Security revenues to cover spending on non-Social Security programs unless there is a majority vote to do so. Theoretically, the vote requirement would have a chilling effect in that it would put on record those who supported such an action.

⁶ Author's calculations from the National Income and Product Accounts. Bosworth (1996) made this point originally.

borrowing costs. The portfolio restructuring would be expected to have some effect on relative returns. The equity premium would decline to reflect the increased efficiency of risk bearing in the economy. Some movement would also be expected in interest rates. One study that has estimated the effect on relative returns concluded that the shift to equities in the trust funds would lower the equity premium by ten basis points and raise the interest on Treasury securities by roughly the same amount (Bohn, 1998). With current levels of federal debt, this increase in Treasury rates should have a relatively small effect on the federal budget. As the economy grows and the debt declines, the effect should be negligible.

While Social Security investment in equities is unlikely to disrupt financial markets or cause major shifts in rates of return, many people are concerned that Social Security investment in equities could lead to government interference with the allocation of capital in the economy and with corporate activity.

In the Social Security debate, both supporters and opponents of trust fund investment in equities point to the performance of public pension funds to argue their case. Supporters cite the success of federal plans, particularly the federal TSP. The TSP has established a highly efficient stock index fund and has steered clear of any issues of social investing. The TSP designers insulated investment decisions by setting up an independent investment board, narrowing investment choices, and requiring strict fiduciary duties. The TSP also operates in a political culture of non-interference. Its creators made clear from the beginning that economic, not social or political, goals were to be the sole purpose of the investment board (Cavanaugh, 1998). The TSP has perpetuated this norm by refusing to yield to early pressure to invest in "economically targeted investments" or to avoid companies doing business in South Africa or Northern Ireland.

It has avoided government interference with private corporations because independent portfolio managers vote the proxies.

Opponents of trust fund investment in equities point to state and local pension funds (Greenspan, 1999). They contend that state and local pensions often undertake investments that achieve political or social goals, divest stocks to demonstrate that they do not support some perceived immoral or unethical behavior, and interfere with corporate activity by voting proxies and other activities. Opponents charge that if the investment options are broadened at the federal level, Congress is likely to use trust fund money for similar unproductive activities.

Recent research documents that political considerations have had almost no effect on investment decisions at the state and local level (Munnell and Sunden, 1999). First, economically targeted investments account for no more than 2.5 percent of total state and local holdings. Although early studies showed plans sacrificing considerable return for targeting their investments to in-state activities, recent survey data reveal no adverse impact on returns as a result of the current small amount of Economically Targeted Investment (ETI) activity. Second, public plans in only three states have seriously engaged in shareholder activism, and this activism appears to have been motivated by a desire to improve the bottom line not to make a political statement. The literature suggests that this activity has had a negligible to positive impact on returns. Third, the only significant divestiture that has occurred was related to companies doing business in South Africa before 1994. This was a unique situation where worldwide consensus among industrial nations led to a global ban on investment in that country. With respect to tobacco, public plans have generally resisted divestiture, and only a few have actually sold their stock. Finally, state and local govern-

ments have borrowed occasionally from their pension funds or reduced their contributions in the wake of budget pressures, but this activity has been restrained by the courts and frequently reversed. Thus, the story at the state and local level is that while in the early 1980s some public plans sacrificed returns for social considerations, plan managers have become much more sophisticated. Today, public plans appear to be performing as well as private plans.

In short, a partially funded defined benefit plan with equity investment is perfectly feasible. Moreover, it can accomplish most of the goals used to justify privatized accounts—such as increasing national saving and offering Social Security participants higher returns—and can do it at lower costs, thus yielding higher net returns. A recent General Accounting Office report (1998) did not identify any insurmountable hurdles with direct trust fund investment in equities. Canada should provide some good information about the feasibility of this type of equity investment, since it has already set up a board that will oversee the investment of its Social Security trust funds in equities.

CONCLUSIONS

Most proposals for restoring financial balance to Social Security that are being discussed today involve both prefunding and equity investment. In economic terms, the goals of prefunding and broadening the portfolio can be achieved either within the context of Social Security's defined benefit program or in personal saving accounts. The question becomes which is the best benefit structure for people's basic retirement income. Here, the economics are clear. A defined benefit plan allows for better risk spreading, lower costs, and better protection for disabled workers and low earners than individual accounts.

Advocates of individual accounts come to their position not because of divergent

economic analysis but because of differing values and political projections. They place different weights on individual control versus shared security. They have different assessments of the long-run stability of the current system and that of a combined defined benefit/defined contribution approach. They have different assessments of the ability to protect accumulations in the trust funds versus individual accounts from political pressures to use them for other purposes. They put different weights on the risk of social investing and corporate interference if the Social Security trust funds purchased equities versus the additional costs associated with setting up individual accounts and regulating their activities. They have different views about the appropriate size of the defined benefit and defined contribution components of the nation's retirement system.

Arguing in favor of maintaining the current defined benefit structure does not mean putting all the nation's eggs in one basket. Two tiers, or even three tiers, are better than one. Since defined benefit and defined contribution plans are subject to different types of risks, a system that combines the two approaches will function better than a system that relies on a single model. But the United States has never tried to provide retirement income through a single plan. By design, Social Security has provided inadequate income to middle and upper income individuals in the expectation that they will supplement these benefits on their own. It has worked, at least in part. Roughly 50 percent of the workforce is covered by supplementary pensions (U.S. Department of Labor, 1994). Many of these supplementary plans started as defined benefit plans but increasingly have shifted to the defined contribution model. On top of that, individuals can save independently through a variety of voluntary tax-subsidized IRAs. In other words, the United States already has many tiers that

combine the defined benefit and defined contribution approaches to providing retirement income. We do not have to privatize Social Security to create still another tier.

In addition to all the economic arguments advanced above against privatizing Social Security, opponents believe that even a small individual account component contains the seeds of dissolution for the entire Social Security program. The fear is that as the mixed defined benefit/defined contribution system develops over time, moderate and high earners will think that they are getting a much better return in their individual account than in the reduced Social Security plan. Of course, the comparison is an unfair one since Social Security must pay benefits to earlier generations of retirees, finance disability and survivor insurance, and provide adequate benefits to low-income workers and women who spend time out of the labor force. Nevertheless, these higher earners will press for further reductions in the traditional defined benefit in order to have more money directed to individual accounts. In the end, Social Security will dissolve into a system of defined contribution accounts plus some form of safety net for the lowest earners. In the process, low earners would lose the redistributive provisions that are so integral to Social Security and crucial to their well being. Instead, the welfare of low earners will depend on some targeted program, subject to all the uncertainties associated with annual appropriation procedures of the Congress. Thus, while individual accounts are merely risky and costly for the average and above average worker, they could end up being disastrous for vulnerable workers in the future.

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